No. 16663

In the United States Court of Appeals for the Ninth Circuit

O. H. KRUSE GRAIN & MILLING, a corporation,
PETITIONER

v.

OMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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INDEX

CITATIONS

Cases—Continued Page

Statute:

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No. 16663

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BRIEF FOR THE RESPONDENT

OPINION BELOW

The Memorandum Findings of Fact and Opinion of the Tax Court (R. 26-41) are not officially reported.

JURISDICTION

This petition for review (R. 43-47) involves federal income taxes for the calendar years 1952 and 1953. On October 29, 1956, the Commissioner of Internal Revenue mailed to the taxpayers a notice of deficiency in the amount of $13,994.26 for the year 1952, and $19,192.33 for the year 1953. (R. 3,

22.) Within ninety days thereafter and on January 28, 1957, the taxpayer filed a petition with the Tax Court for a redetermination of deficiency under the provisions of Section 6213 of the Internal Revenue Code of 1954. (R. 3-22.) The decision of the Tax Court was entered on August 7, 1959. (R. 42.) The case is brought to this Court by a petition for review filed September 14, 1959. (R. 43-47.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether an alleged promissory note issued in 1950 by the taxpayer-corporation to O. H. Kruse, who, with his wife jointly owned all of the taxpayer-corporation's outstanding stock, was a true indebtedness so that accrued interest thereon during the years 1952 and 1953 would be deductible under the provisions of Section 23(b) of the Internal Revenue Code of 1939.

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after Septem-

ber 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

* * * *

(26 U.S.C. 1952 ed., Sec. 23.)

STATEMENT

The facts relevant to this appeal, as found by the Tax Court (R. 28-33), are not in dispute, and may be summarized as follows:

The taxpayer in this case is a corporation organized under the laws of the State of California. It filed its corporate income tax returns for the years 1952 and 1953 with the District Director of Internal Revenue at Los Angeles, California. (R. 28.)

O. H. Kruse, sometimes referred to in the record as Otto H. Kruse, president of the taxpayer corporation, engaged in the hay, grain and feed business as an individual proprietor for fourteen years prior to 1950. In April 1950, Kruse formed the taxpayer corporation, using the same name—O. H. Kruse Grain & Milling—as O. H. Kruse had used in conducting his business as a sole proprietorship. The taxpayer corporation had an authorized capital stock of $300,000, consisting of 3,000 shares of $100 par value each. On April 1, 1950, O. H. Kruse transferred to the taxpayer corporation the following property in exchange for 800 shares of stock issued to himself and his wife jointly * (R. 28, 34):

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* In the interest of simplicity, O. H. Kruse will be referred to hereinafter as the sole stockholder.

Office equipment	$ 1,865.76	
Autos and trucks	57,135.27	
Machinery and equipment	64,113.91	
	$123,114.91	
Less accrued depreciation	44,050.41	$79,064.53
Prepaid insurance		4,163.67
Insurance deposits less accrued premiums		2,293.48
Cash		4,270.55
		$89,792.23

In this transaction the taxpayer corporation assumed liabilities of O. H. Kruse, as follows (R. 29):

Notes payable (bank)	$8,000.00
Accounts payable (trade)	1,710.00
Accrued payroll taxes (due 12/31/50)	82.23
	$9,792.23

The minutes of the meeting of June 15, 1950, of the board of directors of the taxpayer corporation show the following (R. 29):

> Mr. Kruse then stated that he had advanced funds to the corporation for working capital, and that he would be willing to accept the corporation's promissory note for $200,000.00 payable December 31, 1950, to bear interest at the rate of 6% per annum beginning January 1, 1951, if the note should be unpaid on that date. The balance of the advance could be carried as an open account. Payments to Mr. Kruse, other than those on the promissory note, should be applied first to

accrued interest, secondly to accrued rental, and then to the open account.

The following resolution is also contained in these minutes (R. 29-30):

> RESOLVED: That the officers of the corporation be directed to execute a promissory note in the amount of $200,000.00, payable to Mr. O. H. Kruse, payable on December 31, 1950, and to bear interest at the rate of 6% per annum if unpaid on January 1, 1951.

O. H. Kruse conveyed the following assets to the taxpayer corporation and accepted in payment therefor its promissory note in the principal sum of $200,000 and an open account in his favor in the amount of $18,579.29 (R. 30):

Accounts receivable	$139,506.62
Merchandise inventory	37,724.59
Cash	41,348.08
	$218,579.29

The $200,000 note, dated June 15, 1950, provided for the payment of the $200,000 "On or before December 31, 1950 or thereafter on demand", and bore interest at the rate of 6 per cent "from January 1, 1951 until paid, interest payable semi-annually." A corporate journal entry for each month of 1952 and 1953 shows a debit to "Interest" or "Interest Expense" and a credit to "Accrued Interest." These monthly journal entries were posted to ledger sheets entitled "Accrued Interest." (R. 30.)

The taxpayer corporation established a line of credit of $100,000 with the Bank of America on

November 3, 1951, and on said date O. H. Kruse and Helen D. Kruse signed a subordination agreement subordinating the $200,000 note obligation to any existing loan with the bank. In said agreement O. H. Kruse and his wife agreed not to sue, collect or receive payment upon any claim, nor interest thereon, which they held against taxpayer so long as taxpayer owned the bank. (R. 30-31.)

In 1950, the taxpayer corporation deducted accrued interest of $9,000 payable to O. H. Kruse. (R. 31.)

In 1951, the taxpayer corporation deducted $12,000 interest payable to O. H. Kruse. O. H. Kruse, who reported his income on the cash method of accounting at all times, reported no interest from the taxpayer corporation in 1951. No interest was actually paid in 1951. (R. 31.)

In 1952, the taxpayer corporation deducted accrued interest of $12,000 owing to O. H. Kruse. O. H. Kruse reported $6,000 interest from the taxpayer corporation in 1952. No interest was actually paid in 1952. (R. 31.)

In 1953, the taxpayer corporation deducted accrued interest of $12,000 owing to O. H. Kruse. O. H. Kruse reported $12,000 interest from the taxpayer corporation in 1953. The taxpayer corporation actually paid $2,000 interest in September 1953 to O. H. Kruse. (R. 31-32.)

The taxpayer corporation has never paid any dividends. (R. 141.)

Although the taxpayer corporation paid its obligations, other than this note, promptly, it made no

payment on the principal on this note until November 1955, after an Internal Revenue Agent questioned whether the note represented a bona fide indebtedness, thus raising the issue now on appeal. (R. 38.) Thereafter, payments on the principal were made in installments as follows (R. 32):

November 1, 1955	$100,000
April 12, 1957	20,000
October 22, 1958	80,000
	$200,000

The Commissioner disallowed the taxpayer corporation's deductions in the amount of $12,000 for each of the years 1952 and 1953 as interest expense on the ground that no indebtedness existed within the meaning of Section 23(b) of the Internal Revenue Code of 1939 and also on the ground that these amounts were not paid during the taxable years 1952 and 1953 or within 2½ months following the close of the taxable years, pursuant to the provisions of Section 24(c) of the Internal Revenue Code of 1939. (R. 32.)

The Tax Court found as an ultimate fact that the taxpayer corporation's note of June 15, 1950, payable to Otto H. Kruse in the sum of $200,000, was not a bona fide indebtedness and that interest accrued thereon in 1952 and 1953 was not deductible. The Tax Court found it unnecessary to rule on the Commissioner's alternate contention under Section 24(c) in view of the ruling in favor of the Commissioner under Section 23(b). (R. 32.)

SUMMARY OF ARGUMENT

The question presented on this appeal is whether the taxpayer corporation is entitled to an interest deduction under Section 23(b) of the Internal Revenue Code of 1939 for amounts accrued by it as payable upon a note given to the owner of all its stock. Its resolution, in turn, depends on the answer to the narrow question whether the note actually represented a bona fide indebtedness or a capital investment in the corporation. No single characteristic determines the answer to this question, and the presence or absence of any particular factor is not controlling in itself. Thus, the taxpayer, in relying heavily on cases which have held a debt to exist despite the presence of a particular factor which usually indicates a capital investment, errs by failing to recognize that the case must be decided by weighing all the factors present.

An analysis of the record in this case shows a preponderance of factors indicating that in reality the claimed loan was a capital investment, while few earmarks of a loan are present. The note was a demand note and lacked a fixed maturity date on which the principal had to be repaid. The purported lender agreed to subordinate his loan to any loan made to the taxpayer by the Bank of America. Since the "lender" owned all of the stock of the taxpayer corporation, it was not reasonable to expect that he would enforce repayment of the loan if it would inconvenience the corporation. The note was unsecured. It was issued to obtain working capital and assets

essential to start the corporation in business. All of these factors together indicate that the funds advanced were intended to be placed at the risk of the business. In addition, though the transaction was cast in the *form* of a loan, it was not strictly accounted for as a loan. Thus, interest was accrued when it was not even due under the terms of the note; and when interest did become due and was accrued and deducted by the corporation, the "lender" failed to report it as income in his individual income tax return. Significantly, even though the corporation paid its other obligations promptly, it made no payments at all on the principal of this alleged loan for over four years, and then only after the validity of the indebtedness was questioned by an Internal Revenue Agent. The taxpayer proferred no business reason requiring the transaction in question to be considered a loan rather than a capital investment, other than stating that the note was issued in return for assets of the same value—a purpose, however, which could just as easily have been met by the issuance of stock as by executing a note. In this connection, although O. H. Kruse himself was the only one who might have been able to testify that a valid business purpose existed at the time of the transaction which made a loan necessary rather than a capital investment, he did not testify—a circumstance properly regarded by the Tax Court as giving rise to an inference adverse to the taxpayer's position. The taxpayer's treatment of the transaction in question as a loan rather than a capital investment appears to have had no purpose other than tax avoidance. In

this connection, it is not without significance that the taxpayer corporation did not declare or pay any dividends but only accrued an alleged interest obligation in favor of its sole stockholder.

In contrast to the abundant indicia of capital investment here, almost no characteristics of a loan are present. Indeed, the taxpayer's brief is devoted primarily to attempting to explain away the characteristics of an equity relationship; there is very little affirmative emphasis on the existence of a true debt relationship. About all that the taxpayer can say in support of its contention is that the transaction involved was formally designated a loan. This alone, however, is not sufficient; names and terminology used to describe a transaction are not controlling, and tax consequences will be determined by substance and not form. The taxpayer's contention that a loan is indicated because no voting rights were attached to the note is specious, since O. H. Kruse already controlled all voting rights in the corporation through his ownership of all the stock in the corporation.

The issue here must be decided by weighing all the factors present. The taxpayer has the burden of proof, and has failed to meet its burden. The evidence overwhelmingly supports the Commissioner's determination. In any event, the question presented is a factual one and the trial court's determination should not be disturbed unless clearly erroneous. Analysis of the record demonstrates that the Tax Court's decision was not clearly erroneous but was amply warranted.

ARGUMENT

The Tax Court Correctly Held That the Taxpayer Corporation Was Not Entitled To An Interest Deduction Because the Note Given By the Corporation To Its Stockholder Did Not Create a Bona Fide Indebtedness, and This Finding Is Not Clearly Erroneous But Is Fully Supported By the Record

The issue raised by this appeal is whether certain amounts accrued as interest payable by the taxpayer corporation upon a note given by it to the owner of all its stock may be deducted as interest under Section 23(b) of the Internal Revenue Code of 1939. Resolution of this issue, in turn, depends upon whether the note given by the corporation represented a bona fide indebtedness or whether, in reality, it reflected a capital investment in the corporation.

The difference between a debtor-creditor relationship and an investment relationship has been the subject of much litigation. The question has come up often when, as here, the inquiry is whether payments by a corporation should be regarded as interest or dividends; and also when the inquiry has been whether advances made to an unsuccessful corporation should be regarded as bad debts or capital losses. Extended citation of the many cases in this area of tax law would serve no purpose since, as this Court and others have recognized, each case necessarily turns on its own particular facts. *Washmont Corp.* v. *Hendricksen*, 137 F. 2d 306 (C.A. 9th); *Commissioner* v. *Proctor Shop, Inc.*, 82 F. 2d 792, 794 (C.A. 9th); *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159, 165 (C.A. 6th). The decided cases, how-

ever, do offer certain valuable guides in determining whether a debt or an equity relationship exists. No single test is controlling and the presence or absence of any particular factor is not determinative *per se*. As the Supreme Court said in *John Kelley Co.* v. *Commissioner*, 326 U.S. 521, 530:

> There is no one characteristic * * * which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts.

See also, e.g., *Arlington Park Jockey Club* v. *Sauber*, 262 F. 2d 902, 905 (C.A. 7th); *Gilbert* v. *Commissioner*, 262 F. 2d 512, 514 (C.A. 2d); *Crawford Drug Stores* v. *Commissioner*, 220 F. 2d 292, 295 (C.A. 10th). Thus we think the taxpayer here erroneously emphasizes cases which have held a debt to exist despite the presence of a certain factor which usually indicates a capital investment. As indicated in *Kelley*, *supra*, and other cases, whether a debt or a capital investment exists can be properly determined only by considering *all* factors present, or, as the Tax Court here decided, "upon the whole record". (R. 38.)

Turning to the note at issue in this case, we find numerous characteristics supporting the premise of capital investment, and a paucity of factors pointing to a debt relationship. For example, one of the fundamental characteristics of a debt is a definite maturity date on which the principal must be repaid. *Pocatello Coca-Cola Bottling Co.* v. *United States*, 139 F. Supp. 912 (Idaho), citing *Elko Lamoille Power*

Co. v. *Commissioner*, 50 F. 2d 595 (C.A. 9th), and *Commissioner* v. *Proctor Shop*, 82 F. 2d 792 (C.A. 9th); *Parisian, Inc.* v. *Commissioner*, 131 F. 2d 394 (C.A. 5th).[1] The note here is clearly a demand note without a fixed and unqualified maturity date for repayment of the principal. According to its terms, it was payable "on or before December 31, 1950 or thereafter on demand". (R. 30.) The Tax Court correctly characterized it as "a demand note with no right to make demand for about the first six months and the right to fix the maturity date by demand after December 31, 1950".[2] (R. 35.)

Another significant element present here is the agreement signed by O. H. Kruse and his wife to subordinate all claims under the note in question to any loan made by the Bank of America to the corporation. (R. 31.) As was said in *Brinker* v. *United States*, 116 F. Supp. 294, 298 (N.D.Calif.), affirmed *per curiam* by this Court, 221 F. 2d 478:

> When an outside creditor is given complete priority over advances made it is practically an admission that the advances were considered capital advances.

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[1] However, even the presence of a fixed maturity date will not prevent an advance from being a capital investment rather than a loan if other factors indicate the former as its true nature. *Pacific Southwest R. Co.* v. *Commissioner*, 128 F. 2d 815 (C.A. 9th); *Commissioner* v. *Meridian & Thirteenth R. Co.*, 132 F. 2d 182, 187-188 (C.A. 7th).

[2] In fact, no demand for payment and no payment was made until some four years later, in November 1955, after an Internal Revenue Agent questioned whether this note represented a genuine indebtedness. (R. 38.)

The taxpayer suggests (Br. 20) that it is a usual "practice for a bank to require such an agreement in the case of an unsecured loan". This same argument was fully considered in *Sarkes Tarzian, Inc.* v. *United States*, 240 F. 2d 467 (C.A. 7th), and rejected in the following language (p. 470):

> On the question of subordination plaintiff argues that this is a common practice among commercial banks dealing with young and still insecure business organizations, and that subordination is not evidence of an equity investment if all essential rights of the creditor are preserved although postponed. *But subordination necessarily destroys one of the essential rights of the creditor, and the willingness to subordinate is indicative of equity investment.* (Italics supplied.)

The subordination agreement and the lack of a fixed maturity date evince a willingness to place the money at the risk of the business, the essence of a capital investment. As this Court said in *Root* v. *Commissioner*, 220 F. 2d 240, 241:

> A good statement of the distinction between an individual's advances to a corporation as creditor and his advances to a corporation as stockholder is to be found in the decision of the Seventh Circuit in *Commissioner of Internal Revenue* v. *Meridian & Thirteenth Realty Co.*, 132 F. 2d 182, 196, to the following effect: "It is often said that the essential difference between a creditor and a stockholder is that the latter intends to make an investment and take the risks of the venture, while the former seeks a definite obligation, payable in any event."

See also *Gilbert* v. *Commissioner*, 248 F. 2d 399 (C. A. 2d). The fact that Kruse owned all the issued stock of the taxpayer corporation—and could hardly be expected to demand payment of the note by the corporation if such payment would in any way economically inconvenience the corporation—is further indication that he intended to accept the risks of the business. Such lack of intent to enforce payment has been regarded as a feature of an equity, rather than a debt, relationship, since it shows that the obligation was not "payable in any event". *Gooding Amusement Co.* v. *Commissioner*, 23 T. C. 408, 418-419, affirmed, 236 F. 2d 159 (C. A. 6th), certiorari denied, 352 U. S. 1031; *Dobkin* v. *Commissioner*, 15 T. C. 31, 34. The fact that the note was unsecured (R. 38) also indicates a certain willingness to accept the risks of the business. In addition, the minutes of the corporation show that the note was issued by the corporation to obtain working capital (R. 29); and advances for working capital or for assets essential to start a corporation in business indicate capital investment rather than loan. *Schnitzer* v. *Commissioner*, 13 T. C. 43, affirmed per curiam, 183 F. 2d 70 (C. A. 9th), certiorari denied, 340 U. S. 911.

Although the taxpayer relies heavily upon the fact that the transaction here involved was cast in the *form* of a loan, and that a standard note form was used to evidence the transaction, yet the taxpayer's subsequent treatment of this note does not indicate that the parties regarded it as a loan requiring fixed interest and repayment of the principal. The inter-

est was not accounted for as required by the terms of the note. Interest was accrued when it was not even due (1951), and when it did become due and was accrued and deducted by the corporation, it was not reported as income by O. H. Kruse in his individual tax return (1952). (R. 36-37.) Moreover, even though the corporation paid its other obligations promptly, it made no payments at all on the principal of the alleged loan for over four years—and then only after the validity of the indebtedness was questioned by an Internal Revenue Agent. (R. 38.)

Yet another factor tipping the scales in favor of a capital investment, rather than a loan, determination is the lack of any showing of a valid business purpose requiring the transaction at issue to be treated as a loan. Cf. *Gregory* v. *Helvering*, 293 U. S. 465. The only business purpose the taxpayer is able to advance (Br. 12) is that the note was issued for assets having a value equal to the principal amount of the note. However, this is hardly a business purpose *requiring*, or justifying, the loan label, since stock would just as well have been issued to O. H. Kruse for his contribution of the assets. The failure to establish a valid business purpose has been considered of consequence in rejecting the loan hypothesis. *Talbot Mills* v. *Commissioner*, 3 T. C. 95, affirmed, 146 F. 2d 809 (C. A. 1st), affirmed, 326 U. S. 521; *Mullin Building Corp.* v. *Commissioner*, 9 T. C. 350, affirmed, 156 F. 2d 1001 (C. A. 3d); *Schneider Lumber Co.* v. *Commissioner*, decided January 30, 1956 (1956 P-H T. C. Memorandum Decisions, par. 56,025); *Crabtree* v. *Commissioner*, 22 T. C. 61, affirmed *per curiam*, 221

F. 2d 807 (C. A. 2d). In this connection, the Tax Court noted that O. H. Kruse, the only one who might have known of a business purpose, did not testify—a failure which, in the court's view, properly gave rise to an inference adverse to the taxpayer. Cf. *Mammoth Oil Co.* v. *United States*, 275 U. S. 13, 52; *Shaw* v. *Commissioner*, 252 F. 2d 681 (C. A. 6th).

The record in this case discloses no compelling reason for the taxpayer's designation of the transaction here involved as a loan, other than tax avoidance. In this connection we think it significant, as did the Tax Court, that the corporation did not declare or pay any dividends. (R. 141.) See *Crabtree* v. *Commissioner*, 22 T. C. 61, affirmed *per curiam*, 221 F. 2d 807 (C.A. 2d).

Against the abundant indicia of capital investment, the signs of a loan are scant. Indeed, the taxpayer's brief is devoted primarily to explaining away the abundant earmarks of a capital investment present here; there is little affirmative discussion to show that a debt existed. About all that the taxpayer is able to say in support of its loan premise is that the transaction involved was formally called a loan. A note was issued which was called a note, and the transaction was recorded as a loan on the books of the corporation. But such formalistic designation alone is not sufficient; the terminology used to describe a transaction is not controlling. *John Kelley Co.* v. *Commissioner*, 326 U. S. 521, 530; *Commissioner* v. *Proctor Shop, Inc.*, 82 F. 2d 792, 794 (C. A. 9th); *Brown-Rogers-Dixson Co.* v. *Commissioner*, 133

F. 2d 347, 349 (C. A. 4th); *John Wanamaker Philadelphia* v. *Commissioner*, 139 F. 2d 644, 646 (C. A. 3d); *Parisian, Inc.* v. *Commissioner*, 131 F. 2d 394 (C. A. 5th); *Gilbert* v. *Commissioner*, 248 F. 2d 399, 402 (C. A. 2d). Moreover, any one attempting to disguise a capital investment as a loan solely for tax purposes would very likely designate the transaction as a debt in every formal way possible; but, of course, the tax consequences of the transaction will be determined by its substance, not its form. The taxpayer also contends (Br. 15) that the note's lack of voting rights supports the loan premise, but this argument is specious; O. H. Kruse already controlled all voting rights in the corporation through his ownership of all the stock in the corporation.

As stated above, the proper resolution of the issue at hand depends, not upon any one, but upon a weighing of all factors present, and a consideration of the substance of the transaction. The burden of proof on this issue was on the taxpayer. *Arlington Park Jockey Club* v. *Sauber*, 262 F. 2d 902, 905 (C. A. 7th); *Wetterau Grocer Co.* v. *Commissioner*, 179 F. 2d 158, 160 (C. A. 8th); *First Mortgage Corp.* v. *Commissioner*, 135 F. 2d 121, 124 (C. A. 3d).

Moreover, this Court, as well as others, has often held that the precise question presented here is a question of fact and that the trial court's determination will not be disturbed unless clearly erroneous. See, e.g., *Earle* v. *W. J. Jones & Son*, 200 F. 2d 846, 847 (C. A. 9th); *Grace Bros.* v. *Commissioner*, 173 F. 2d 170 (C. A. 9th); *Root* v. *Commissioner*, 220 F. 240 (C. A. 9th); *Cohen* v. *Commissioner*, 148 F. 2d

336 (C. A. 2d). In *Earle* v. *W. J. Jones & Son*, *supra*, this Court said (pp. 847-848):

> And we should be reluctant to disturb the finding of the trial court where, as here, the question whether the advances gave rise to debts or to a proprietary interest depends upon the determinative *intent* of the parties to the critical advances.

The taxpayer has failed to demonstrate that the Tax Court's decision was clearly erroneous, and there is no reason why this Court should overcome its stated reluctance to reverse an ultimate factual finding of the court below which was fully supported by the record.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

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